Supreme Court, U.S.
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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

ARCHER-DANIELS-MIDLAND COMPANY, on its own behalf and as common parent of an affiliated group of corporations, FLEISCHMANN-KURTH MALTING COMPANY, INCORPORATED, and COEVAL, INCORPORATED,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Can a clear statutory provision be overridden by an equally clear but inconsistent statement in congressional committee reports?

2. In determining whether statutory language has more than one plausible interpretation, can an interpretation be deemed plausible if it involves reading an introductory clause to imply a limitation on the first of the three mathematical formulae it governs when it is undisputed that the limitation should not be applied to the third formula?

RULE 29.1 STATEMENT

The parents and subsidiaries (other than those that are wholly owned or otherwise not publicly held) of the parties to the proceeding in the lower courts are:

Acatos & Hutcheson Plc.
American Maize-Products Co.
Overseas Shipholding Group, Inc.
Pilgrims Pride Corporation

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PETITION FOR A WRIT OF CERTIORARI

Archer-Daniels-Midland Company ("ADM"), on its own behalf and as common parent of an affiliated group of corporations, Fleischmann-Kurth Malting Company, Incorporated and Coeval, Incorporated, petition for a writ of certiorari to the United States Court of Appeals for the Seventh Circuit.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-8a) is reported at 37 F.3d 321 (7th Cir. 1994). The opinion of the district court (App., *infra*, 9a-24a) is reported at 798 F. Supp. 505 (C.D. Ill. 1992).

JURISDICTION

The judgment of the court of appeals was entered on October 3, 1994. A petition for rehearing with a suggestion for rehearing en banc was denied on November 2, 1994. App., *infra*, 25a-26a. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

26 U.S.C. § 994(a),[1] as in effect at the relevant time, provided as follows:

> (a) IN GENERAL.—In the case of a sale of export property to a DISC by a person described in section 482, the taxable income of such DISC and such person shall be based upon a transfer price which would allow such DISC to derive taxable income attributable to such sale (regardless of the sales price actually charged) in an amount which does not exceed the greatest of—
>
> > (1) 4 percent of the qualified export receipts on the sale of property by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts,
> >
> > (2) 50 percent of the combined taxable income of such DISC and such person which is attributable to the qualified export receipts on such property derived as the result of a sale by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts, or
> >
> > (3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482).[2]

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[1] Unless otherwise indicated, all section references herein are to the Internal Revenue Code, 26 U.S.C., as in effect at the relevant time, or to the regulations promulgated thereunder, 26 C.F.R.

[2] Section 482 requires related parties to set fair market prices for their transactions—(i.e., prices that would result from arm's

Treasury Regulation § 1.994-1(e)(1)(i), the "no-loss rule," provides as follows:

> (e) *Methods of applying paragraphs (c) and (d) of this section—(1) Limitation on DISC income ("no loss" rule)—(i) In general.* Except as otherwise provided in this subparagraph, neither the gross receipts method nor the combined taxable income method may be applied to cause in any taxable year a loss to the related supplier, but either method may be applied to the extent it does not cause a loss. A loss to a related supplier would result if the taxable income of the DISC would exceed the combined taxable income of the related supplier and the DISC. If, however, there is no combined taxable income of the DISC and the related supplier (because, for example, a combined loss is incurred), a transfer price (or commission) will not be deemed to cause a loss to the related supplier if it allows the DISC to recover an amount not in excess of its costs (if any).

STATEMENT

A. The Statutory Scheme

In order to improve the balance of payments by encouraging exports by U.S. companies, Congress in 1971 added to the Internal Revenue Code provisions governing DISCs—Domestic International Sales Corporations. App., *infra*, 2a. These provisions permitted U.S. companies to obtain tax benefits by using a separate corporation—a DISC—as a vehicle for making export sales. *Id.* A DISC could either buy the export property from its related company at a bargain price and resell it abroad, or it could be deemed a sales agent for the related company and be paid a commission on the sale. *Id.* at 11a. The DISC would realize income on the transactions, but the payment of tax was deferred on about half the income. *Id.* at 10a-11a. Meanwhile, the bargain sale or

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length negotiations between unrelated parties). Thus, the third formula simply provides that the prices be set at fair market value.

commission payments to the DISC reduced the taxable income of the related party. *See id.*

The greater the income the DISC realized, the greater the tax deferral to the related party. Through section 994(a)—set forth above—Congress carefully limited the income that could be attributed to the DISC: the price in the transaction between the DISC and the related party had to be set so that the DISC's taxable income did not exceed the amount computed under whichever of the three pricing formulae the taxpayer elected. App., *infra*, 2a.

In 1975, the Internal Revenue Service ("IRS") issued the so-called no-loss rule which provided that the intercompany pricing formulae of section 994(a)(1) (4 percent of export receipts) and section 994(a)(2) (50% of combined taxable income) would not apply to the extent that the price so calculated would "cause in any taxable year a loss to the related supplier." App., *infra*, 11a. The no-loss rule expressly provided that the no-loss limitation does not apply to the arm's length pricing formula of section 994(a)(3). *See* App., *infra*, 13a.

B. ADM's DISC Transactions

ADM established a DISC, and during the years 1975 through 1978 ADM and its related companies used the DISC to make over $3.5 billion in qualified export sales. In establishing the prices for the transactions with its DISC, ADM elected the first of the three pricing alternatives under section 994(a): the transactions with the DISC were priced so that the DISC realized taxable income equal to "4 percent of the qualified export receipts."[3]

ADM's application of the 4-percent-of-exports formula resulted, in some cases, in losses to ADM on its export

[3] Section 994(a) literally governs the pricing only for DISCs that buy and resell the export property, not for DISCs that act as commission agents. Section 994(b), however, directs the Secretary of the Treasury to prescribe regulations for commission DISCs that are consistent with the rules in section 994(a). Those regulations appear at 26 C.F.R. § 1.994-1(d).

sales. Recognizing that the no-loss rule purported to proscribe such a result, ADM filed its tax returns in conformity with the no-loss rule and paid the taxes shown as due of those returns. App., *infra,* 14a. It then claimed a refund on the ground that the no-loss rule was invalid because it squarely conflicted with the statutory language which imposed no such limit on the 4-percent-of-gross-receipts formula. *Id.* at 15a. Following denial of the refund claim, it commenced this refund action in the United States District Court for the Central District of Illinois. The jurisdiction of the district court was based on 28 U.S.C. § 1346(a)(1).

C. Proceedings Below

The sole issue before the district court was the validity of the no-loss rule.[4] App., *infra,* 9a. Because there was no dispute as to any material facts, the parties cross-moved for summary judgment. *Id.* The district court held that the language of section 994(a)(1) unambiguously permitted ADM to set the price in its DISC transactions so that the DISC realized taxable income equal to 4 percent of gross export receipts, notwithstanding that this generated losses for ADM on its export sales. App., *infra,* 22a-24a. It thus held that the no-loss rule represented an impermissible attempt to alter the clear mathematical formula set forth in the statute. *See id.* at 22a. The court recognized that the no-loss rule was consistent with a sentence in the congressional committee reports,[5]

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[4] The complaint also addressed the tax treatment of certain insurance transactions, but the parties settled that issue.

[5] The following language relating to sections 994(a)(1) and (2) appeared in the two committee reports:

> Under the first of the two new rules, a DISC may earn that portion of the combined taxable income arising on the sale by a DISC of export property purchased from a related person which does not exceed 4 percent of the qualified export receipts from the sale, plus 10 percent of the DISC's export promotion expenses attributable to the sale. Income may not,

but it held that those reports could not override the clear statutory language. *Id.* at 22a-23a. The district court thus granted summary judgment for ADM for a refund of $17,908,898 in taxes, plus interest. *Id.* at 27a-28a.

In a 2-1 decision, the court of appeals reversed. *Id.* at 1a-8a. The majority did not suggest that ADM's interpretation of the statute was inconsistent with the statutory language or that it would lead to any absurd result. In a single sentence, however, the majority suggested that reading the introductory language of section 994(a) as implying that the 4-percent-of-gross-receipts method is capped at the amount of taxable income derived from export sales "is not inevitable, but it is plausible," and thus justifies the no-loss rule which is supported by the sentence in the committee reports. App., *infra*, 5a. The majority defended its reliance on legislative history by stating that "the slogan that Congress votes on the bill and not on the report strikes us as pretty empty"; and further, that "[i]f [a member of Congress] (or his staff) cannot rely on [committee reports] as a guide to the meaning of the statute, we are not sure what he is supposed to do." *Id.* The dissenting opinion concluded that "Congress did not enact the 'no-loss rule,' " and it would thus have affirmed the judgment of the district court. *Id.* at 8a.

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however, be allocated to the DISC under this (or the second) rule to the extent it would result in the related person who sold the products to the DISC incurring a loss on the sale.

H.R. Rep. No. 533, 92d Cong., 1st Sess. 74 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1825, 1887; S. Rep. No. 437, 92d Cong., 1st Sess. 107-08 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1918, 2013.

REASONS FOR GRANTING THE PETITION

The Court should grant this petition in order to resolve two important and related issues regarding the proper use of legislative history in construing statutes. The importance of this case does not derive from the significance of the particular statutory language involved; indeed, the DISC provisions were supplanted after 1984 by foreign sales corporations provisions that contain an explicit income limitation on the comparable gross receipts formula.[6] It is thus unlikely that the construction of this particular language is of enduring significance. In contrast, however, the two issues regarding the use of legislative history in statutory construction are of signal importance, and the resolution of those issues by the Seventh Circuit conflicts with decisions of other courts of appeals and threatens to eviscerate this Court's pronouncements on the subject. Moreover, this case is a singularly appropriate vehicle for this Court to use to resolve these issues because it is not plagued by (1) any dispute as to the facts (indeed, the facts were stipulated) or (2) any conflict within the legislative history (the parties agree that the only legislative history that addresses the issue is the sentence that appears in the committee reports that supports the IRS position).

This Court has held that the plain language of a statute will control, notwithstanding legislative history to the contrary, except in exceptional circumstances. There is no claim that this case presents an exceptional circumstance such as a scrivener's error or a literal wording of a statute that produces an absurd and clearly unintended result. The court of appeals recognized that the taxpayer's interpretation more broadly carries out the statutory purpose of encouraging exports (App., *infra*, 4a); moreover, the statute's balance-of-payments objective is directly served by export receipts without

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[6] Section 925(d).

regard to the amount of income they produce.[7] Nor is this a case in which the legislative history serves to define a word or phrase in the statute that at first might have appeared clear but whose ambiguity is revealed by the legislative history; the committee reports state that there is a no-loss limitation, but they point to no language in the statute as the source of that limitation. Instead, the statute prescribes three pricing formulae with specificity, and a sentence in the committee reports simply asserts a limitation on two of the three pricing formulae that has no roots in any statutory language.

The court of appeals erred in two important respects in upholding the no-loss rule. First, the court carved out a new and unwarranted exception to the proposition that the plain language of a statute should control. Ignoring this Court's holdings to the effect that committee reports cannot be treated as law (although they can shed light on the meaning of words used in a statute), the court of appeals held that committee reports should dominate statutory construction in complex areas such as the tax code (*See* App., *infra*, 5a), where congressmen allegedly lack the time to study the statute and thus rely on the committee reports.

Second, and even more perniciously, the court of appeals adopted an approach that guts the basic proposition that the plain language of a statute should govern. To justify its reliance on legislative history, it suggested (in a single sentence) that the statute was ambiguous because a suggested interpretation of a phrase in the introductory

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[7] The court of appeals noted that absent the no-loss rule the DISC provisions would enable ADM to reduce the taxes payable with respect to non-export activities. App., *infra*, 3a-4a. Under the Internal Revenue Code, however, it is the rule, not the exception, that credits or deductions designed as an incentive for one activity may be used to decrease the tax liability with respect to other activities. *E.g.*, section 66 (investment tax credits); section 167(k) (accelerated depreciation). The incentive for the desired activity is provided by any reduction of tax liability, whatever the source of that liability.

language of section 994(a) arguably would render "plausible" the IRS's interpretation of the statute. App., *infra*, 5a. The suggested interpretation of that introductory phrase not only stretches those words beyond any normal reading, it leads to an impossible result because the phrase introduces and governs all three pricing formulae and it is undisputed that the limitation the court of appeals reads into the language does not in fact apply to the third formula. Thus, the court of appeals holds that a statute should be treated as ambiguous even when there is only one construction that does not lead to a grammatical and logical contradiction. If that is the case, then the basic proposition about honoring the clear language of a statute becomes meaningless, because all it takes to circumvent that proposition is the assertion of a litigating position (regardless of its grammatical and logical indefensibility) that the statute admits of more than one interpretation.

I. THE PETITION SHOULD BE GRANTED TO OVERRULE THE HOLDING THAT LEGISLATIVE HISTORY CAN OVERRIDE THE LANGUAGE OF A STATUTE THAT IS COMPLEX OR TECHNICAL

With very rare exceptions, an unambiguous statute should be given its plain meaning, notwithstanding legislative history to the contrary. *Patterson v. Shumate*, 112 S. Ct. 2242, 2248 (1992); *Rubin v. United States*, 449 U.S. 424, 430 (1981). This Court has recognized, however, that legislative history can play an important role in statutory construction. For example, it can reveal what Congress really intended when the statutory language yields an absurd and obviously unintended result. *See, e.g., Green v. Bock Laundry Machine Co.*, 490 U.S. 504, 527 (1989) (Scalia, J., concurring). Most commonly, it can shed light upon the intended meaning of statutory words and phrases, thus facilitating a choice among competing reasonable interpretations of a statute. *See, e.g., Atkins v. Parker*, 472 U.S. 115, 124-26 (1985). The court of appeals, however, did not use legislative his-

tory in any such appropriate fashion; rather, it misused legislative history by relying on it to override statutory language on the theory that, in the case of complex and technical statutes such as the Internal Revenue Code provisions at issue here, the committee reports, rather than the statutes themselves, are the focal points for congressmen and their staffs. *See* App., *infra*, 5a.

The court of appeals emphasized the role it would accord legislative history:

> Legislative history is in bad odor in some influential judicial quarters, see, e.g., *United States v. Taylor*, 487 U.S. 326, 344-46 (1988) (concurring opinion) but it continues to be relied on heavily by most Supreme Court Justices and lower-court judges; and in the case of statutory language as technical and arcane as that of the DISC provisions, the slogan that Congress votes on the bill and not on the report strikes us as pretty empty. Even advised by his personal staff a member of Congress would have great difficulty figuring out the purport of 26 U.S.C. § 994(a)(1) without the aid of the committee reports. If he (or his staff) cannot rely on them as a guide to the meaning of the statute, we are not sure what he is supposed to do.

App., *infra*, 5a. Thus, the court of appeals' view is that in the case of complex statutes (including, presumably, those that upon careful review would admit of only one reasonable interpretation), a court may skip over the statutory language and go straight to the committee reports to ascertain the statute's meaning. Yet it is exactly such a usage that gives legislative history the "bad odor" to which the court refers, with the resulting pressure for development of overly restrictive principles of statutory construction.

The court of appeals' view is erroneous and demands correction. This Court, quite properly, has not created a complexity exception to the principle that unambiguous statutory language controls; it has never held that statutes

must be both plain and simple to merit construction by reference to their language rather than to unenacted legislative history.

Complex statutes *may* prove ambiguous more often than simple statutes, but that is by no means clear. Quite possibly, the interrelationship between the provisions of a complex statute, and the use of the same words in several places, may eliminate some otherwise reasonable constructions. Moreover, regardless of whether complex statutes are generally more prone to ambiguity than their simple counterparts, there is no basis for permitting legislative history to trump particular statutory language that, although complex, admits of only one reasonable construction.

The court of appeals opinion was not only wrong, it demands correction by this Court. Admittedly, this Court has often ruled that legislative history should not override clear statutory language, and an isolated court of appeals decision that overlooked that rule might do little to upset that body of precedent. This court of appeals decision, however, could be construed as an exception to or refinement of the general principle in the case of complex statutes. This decision could thus spawn erroneous decisions from courts even though they are well aware of the general principle this Court has adopted.

The view of statutory construction adopted by the court of appeals in this case is particularly troublesome if it is accepted as a principle of construction of tax provisions. The Internal Revenue Code is extremely complicated, and those complications apply to millions of taxpayers.[8] The cost to taxpayers of compliance is presently enormous,[9] and that cost would substantially increase if, as the court

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[8] "[The] present tax law has spun out complications to the extent that it is truly monstrous." Erwin N. Griswold, *Is the Tax Law Going to Seed?*, 11 Am. J. Tax Pol'y 1. (1994).

[9] The estimated 1993 costs to U.S. business of Federal tax compliance is $123.4 billion. Arthur P. Hall, *The High Cost of Tax Compliance for U.S. Business*, 63 Tax Notes 887 (1994).

of appeals holds, it is not sufficient to comply with the clear language of a statute if that language is not entirely consistent with legislative history.

This Court should take this opportunity to affirm that clear language of the Internal Revenue Code prevails in the absence of a patent scrivener's error or the creation of an absurd result, that the court of appeals' view to the contrary in this case is rejected, and that the governing principle is that applied by the Fifth Circuit in *Nalle v. Commissioner*, 997 F.2d 1134, 1140 (5th Cir. 1993), which stated, in the course of holding a Treasury regulation invalid:

> The Commissioner cannot explain away this ultimate incompatibility of his regulation with the statute by reference to the legislative history; where a plain reading of the statute precludes the Commissioner's interpretation, no legislative history—be it ever so favorable—can redeem it.

The Fifth Circuit recognized that a substantial additional burden would be imposed on taxpayers if plain language included as a part of complex tax legislation cannot be relied on without first searching for inconsistencies in unenacted materials. In sharp contrast, the court of appeals opinion in this case in effect suggests that a member of Congress (or his staff) need not be concerned with statutory language—if he cannot rely on committee reports as a guide to meaning, "we are not sure what he is supposed to do." App., *infra*, 5a.

Contrary to the court of appeals opinion, other circuit courts construing the Internal Revenue Code or other complex legislation similarly have rejected use of legislative history to override clear statutory language despite such complexity. *See, e.g., International Brotherhood of Electrical Workers, Local Union No. 474 v. NLRB*, 814 F.2d 697 (D.C. Cir. 1987) (National Labor Relations Act); *Edwards v. Valdez*, 789 F.2d 1477 (10th Cir. 1986) (Federal Unemployment Tax Act).

II. THE PETITION SHOULD BE GRANTED TO ESTABLISH THAT AN INTERPRETATION OF A STATUTE THAT LEADS TO INTERNAL CONTRADICTIONS IS NOT PLAUSIBLE

The court of appeals' sole attempt to reconcile its interpretation of the statute with the statutory language was its passing suggestion that a phrase in the introductory language of section 994(a) can plausibly be read as imposing a no-loss limitation on the "4 percent of the qualified export receipts" test of section 994(a)(1). App., *infra*, 3a. Even if (contrary to fact) this were a plausible construction of the phrase viewed in isolation, it is an impossible interpretation here because that language applies equally to all three pricing formulae, and it is undisputed that the no-loss limitation does not apply to the third pricing formula.

As noted above, the introductory language of section 994(a) allows the taxpayer to establish a price for the transactions with its DISC so as to allow the DISC "to derive taxable income attributable to [the export] sale" in an amount that does not exceed the greatest of the amounts computed according to the three formulae that follow: the 4-percent-of-qualified-export-receipts test of section 994(a)(1), the 50-percent-of-combined-profits test of section 994(a)(2), and the arm's-length-pricing test of section 994(a)(3). The court of appeals did not suggest that any language in section 994(a)(1) itself imposes a no-loss limitation. Rather, it finds this limitation in the introductory language. The entire discussion of the relevant language by the court is as follows:

> The exporter is allowed to fix a transfer price that will allow its "DISC to derive taxable income *attributable* to [the export] sale," 26 U.S.C. § 994(a), and in our hypothetical sale ADM has no income from its export sales. To read section 994(a) as implying that the 4-percent-of-gross-receipts method of calculating DISC income in subsection (1) is capped at the

> amount of taxable income derived from export sales is not inevitable, but it is plausible . . . .

App., *infra*, 5a.

Even assuming that the phrase "derive taxable income attributable to [the export] sale" could, in isolation, be read as imposing a no-loss limitation, the structure of the statute precludes such an interpretation here. The introductory language of section 994(a), including the quoted phrase, governs the arm's length formula of section 994(a)(3) to the same extent that it governs the 4-percent formula of section 994(a)(1). The IRS, however, acknowledges that the arm's length method is not subject to any no-loss limitation, and the no-loss regulation so provides both by text and example.[10] *See* Treas. Reg. § 1.994-1(e)(1)(i) and (g) Example (5). Yet if this is the case, then the introductory language of section 994(a) cannot possibly be read to impose a no-loss limitation. It is grammatically impossible to argue that the introductory language limits the 4-percent formula without limiting the arm's length formula.

Given that the introductory language applies to both of these formulae, the court of appeals necessarily gives the very same phrase two different meanings when applied to the two formulae, an approach that defies both logic and precedent. As this Court recently observed, "[a]mbiguity is a creature not of definitional possibilities but of statutory context." *Brown v. Gardner*, 115 S. Ct. 552, 555 (1994). In *Ratzlaf v. United States*, 114 S. Ct. 655, 660, 662 (1994), this Court held that a single formulation of statutory text should be construed the same way each time it is called into play, despite "contrary indications in the statute's legislative history." In *Brown*,

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[10] Likewise, the committee reports state a no-loss limitation only with respect to the first two pricing formulae, not to the arm's length formula. *See supra*, at 5 n.5.

this Court emphasized that the "presumption that a given term is used to mean the same thing throughout a statute . . . [is] surely at its most vigorous when a term is repeated within a given sentence." 115 S. Ct. at 555 (citation omitted). The present case is even more extreme; it involves a single phrase unambiguously applied equally to all three subsections indented beneath it.

We recognize that there may be statutes that, because of errors in drafting, admit of no interpretation that avoids grammatical error or logical contradiction. In such cases, courts of necessity must select one of the imperfect choices before them. This is not such a case. Neither the IRS nor the court of appeals was able to identify any grammatical or logical contradiction, or inconsistency with the clear statutory purpose, ensuing from ADM's construction of the statute. Simply put, ADM's construction works, and the IRS's construction does not.

Even absent the contradiction noted above, the meaning the court of appeals ascribes to the phrase in question would not qualify as plausible. The introductory language provides for setting a price for the transaction with the DISC so that the DISC "derive[s] taxable income *attributable* to [the export] sale" (App., *infra*, 5a) not in excess of that allowed by the three formulae that follow. The court of appeals decision rests on its suggestion that it is plausible to read the phrase "attributable to" to impose a no-loss limitation. *See id.* To the contrary, such a reading is not plausible. If income equal to 4 percent of export receipts is "attributed to" the DISC, then by definition this is income "attributable to" the DISC's export sales. There is nothing about the phrase "attributable to"—or any other words in the introductory language of section 994(a)—that suggests that the DISC's income cannot exceed the combined income on the export sales, thus generating a loss for the DISC's related supplier.

The court of appeals reads the statute as if (1) it allocated a certain limited amount—the combined taxable income on the export sale—between the DISC and the

related supplier, and (2) taxable income cannot be negative. *See* App., *infra*, 5a-6a. Both propositions must be true to support the court of appeals' position. In fact, neither is. The statute does not state or imply that it is dividing up a specified amount of income between the DISC and the supplier; it speaks instead of establishing the DISC's income by attributing (not "allocating") to the DISC 4 percent of ADM's export *receipts* without reference to ADM's export income. (The supplier's income is thus a result, not a determinant, of the DISC's income.) Moreover, it is undisputed that taxable income may be positive or negative under the Internal Revenue Code;[11] thus, even if section 994(a) were viewed as dividing up taxable income, that would be fully consistent with assigning taxable income equal to 4 percent of receipts to the DISC and a negative amount of taxable income to the supplier.

This Court should grant the petition in order to make clear that the IRS and courts cannot circumvent the principle that legislative history cannot override an unambiguous statute simply by finding a statute to be ambiguous whenever a party formulates a litigating position, however strained, that two meanings are possible. Where, as here, one interpretation is a plain reading of the words, leads to no logical problem, more directly serves the clear statutory purpose of providing export incentives, and produces no absurd result, an alternative interpretation

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[11] Section 63(a) defines "taxable income" as "gross income minus the deductions allowed by" the Code. Treasury Regulation § 1.61-3(a) defines "gross income" as "total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources." Thus, "gross income" and "taxable income" can be negative amounts. *Cf. G.U.R. Co. v. Commissioner*, 117 F.2d 187 (7th Cir. 1941) (allocating to a related party a *loss* on a sale of stock under the predecessor of section 482 (which provision authorized allocation of gross income or deductions)). When Congress wants to limit "taxable income" to a positive amount, it does so in the statute. *See, e.g.*, section 172(b)(2) ("the taxable income so computed shall not be considered to be less than zero").

that leads to a logical contradiction cannot be deemed plausible. In such a case, the statute (having only one plausible interpretation) is unambiguous and legislative history cannot be used to trump the statutory language.

This issue is of unusual significance. A party (or a court) in any case can propound multiple interpretations of statutory language. If the mere articulation of multiple interpretations, without regard to whether more than one interpretation creates a logically consistent statute, suffices to generate an ambiguity that merits resort to legislative history, then the principle that unambiguous statutory language should govern has been effectively gutted. The Court should grant the petition to establish that this essential principle of statutory construction is not so easily evaded.

III. THIS CASE IS A PARTICULARLY APPROPRIATE VEHICLE FOR CLARIFYING THE PERTINENT LEGAL PRINCIPLES

This case represents a particularly good vehicle for clarifying the legal principles regarding the use of legislative history in statutory construction.

First, because the facts are fully stipulated, the case presents a pure question of law.

Second, this is the rare case where there is no conflict in the legislative history. If using legislative history to construe statutes may properly be viewed as "looking over a crowd and picking out your friends," [12] then ADM may properly be viewed as without friends. Although one can question the extent to which a single sentence in the committee reports expresses statutory intent, there are no contrary statements. Thus, the case presents a question of when legislative history is material, not about which party finds more support in that history.

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[12] Patricia M. Wald, *Some Observations on the Use of Legislative History in the 1981 Supreme Court Term*, 68 Iowa L. Rev. 195, 214 (1983) (quoting Judge Leventhal).

CONCLUSION

Nothing in the statutory language explicitly imposes a no-loss limitation on the DISC pricing formulae. Moreover, it is not conceivable that one would read the introductory language of section 994(a) to imply such a limitation unless, prompted by the sentence in the committee reports, one consciously strove to find a statutory phrase on which to attempt to justify the reports. That is what the court of appeals did here. Contending that committee reports depict what Congress really intended, the court of appeals imposed a construction on a statutory phrase that conflicts with the normal usage of the statutory words and that leads to a clear internal contradiction. Legislative history surely has an important role to play in statutory construction, but not the role allotted to it here. The Court should grant the petition to clarify the presently somewhat confused principles governing statutory construction and to distinguish between the proper use and the abuse of legislative history.

Respectfully submitted,

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APPENDICES

APPENDIX A

IN THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

No. 93-3939

ARCHER-DANIELS-MIDLAND COMPANY, on its own behalf and as common parent of an affiliated group of corporations, FLEISCHMANN-KURTH MALTING COMPANY, INCORPORATED, and COEVAL, INCORPORATED,
Plaintiffs-Appellees,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant.

Appeal from the United States District Court
for the Central District of Illinois, Danville Division
No. 89 C 2325—Harold A. Baker, *Judge*

ARGUED MAY 17, 1994—DECIDED OCTOBER 3, 1994

Before POSNER, *Chief Judge*, and HILL* and RIPPLE, *Circuit Judges.*

POSNER, *Chief Judge.* The district judge ordered the government to refund some $18 million in taxes (plus a good deal of interest, since the taxable years in suit are

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* Hon. James C. Hill of the Eleventh Circuit, sitting by designation.

1975 through 1978) to Archer-Daniels-Midland, the agricultural giant; and the government appeals. The quarrel is over the meaning of the "DISC" provisions of the Internal Revenue Code, 26 U.S.C. §§ 991-997, which allowed exporters such as ADM to defer federal income tax on income (or, as ADM would have it, on gross receipts in some cases) obtained from those exports. We say "allowed" (past tense) because these provisions have been superseded by the provisions on Foreign Sales Corporations, 26 U.S.C. §§ 921-27; see 2 Joseph Isenbergh, *International Taxation: U.S. Taxation of Foreign Taxpayers and Foreign Income* ¶ 33.3 (1990), though issues similar to those in this case may arise under the successor provisions as well. See 26 C.F.R. § 1.925(a)-1T(e)(1).

Here is how the tax shelter, created in 1971 to stimulate agricultural exports (though not limited to such exports), worked. The exporter creates a DISC (Domestic International Sales Corporation), which is simply an accounting entity that has the happy property of not being subject to federal income tax, although some of its income is taxed to the DISC's owner (in this case ADM) at once and the rest is taxed to him later. The DISC's income is determined by the price at which the owner (called a "related supplier") transfers output to it for sale abroad nominally by the DISC. The tax benefits of exporting through a DISC would be maximized if the owner could set a transfer price of zero, for then his entire export income would be attributed to the DISC. Congress didn't want to go that far to stimulate exports, so it provided in 26 U.S.C. § 994(a) that the taxable income of the DISC and of the DISC's owner "shall be based upon a transfer price which would allow such DISC to derive taxable income attributable to such [export] sale (regardless of the sale price actually charged) in an amount which does not exceed the greatest of—" and three alternatives are listed. Only two need be discussed. The second—logically the first as it seems to us, since the statute is designed to shelter income made in export sales

—is 50 percent of "the combined taxable income of the DISC and [its owner] which is attributable to the" export sale, plus some expenses which we can ignore. § 994 (a)(2). The first—logically the second because it is designed to provide a benefit when the income from the export sale is too slight to yield a substantial benefit under the first subsection—is "4 percent of the qualified export receipts on the sale of property by the DISC" plus, again, certain expenses that we can ignore. § 994(a)(1). ADM argues, and the district court agreed, 798 F. Supp. 505 (C.D. Ill. 1992), that this subsection allows it to set a transfer price that will give the DISC taxable income (taxable to the DISC's owner that is, with some of the tax deferred) equal to 4 percent of ADM's gross receipts from agricultural exports.

The Treasury Department disagrees. In an interpretive regulation that the district court invalidated, 26 C.F.R. § 1.1994-1(e)(1)(i), the Department takes the position that subsection (1) of section 994(a) in effect supplements subsection (2). Subsection (2) allows the exporter to shift half its export income to the DISC; but should its total income, and therefore one half of that total, be meager (it might be zero), it can use subsection (1) to shield a percentage of its gross receipts (a larger figure than income) up to 4 percent. So, for example, if the exporter has sales of $100, and income of $10, it can shift $5 to the DISC via subsection (2), because $5 is 50 percent of $10. But if its income were only $6, it could shift $4 to the DISC by using subsection (1) instead, since $4 is 4 percent of $100. That is under the regulation. But under ADM's and the district judge's interpretation, even if the combined income of the DISC and its owner is zero or even negative, the owner can still shift income equal to 4 percent of its export sales to the DISC—provided that it has income elsewhere in its business, for otherwise the maneuver would confer no benefit on it.

Suppose, then, that ADM had just two divisions, and one exported agricultural products and the other manufactured children's toys for sale in the United States, and the first just broke even and the second was profitable; the first had gross receipts of $100, costs of $100, and income therefore of zero (so that subsection (2) would be worthless to it), and the second had income of $10 (its gross receipts and costs are irrelevant). ADM would fix a transfer price to the DISC of $96, generating income of $4 for the DISC, that being 4 percent of ADM's gross receipts from exports. Since ADM's total income is in fact only $10 in this example, none of it export income, the effect of its maneuver would be—if ADM's interpretation of the statute is sustained—to obtain favorable tax treatment for 40 percent of its domestic income.

ADM is right to point out that the basic purpose of the DISC program—the encouragement of agricultural exports—would be served by such an interpretation, because it would encourage unprofitable as well as profitable, exports, whereas the Treasury Department's interpretation would encourage only the profitable ones. But reference to purpose cannot be conclusive in a case, such as this, where neither interpretive alternative would thwart the statute's purpose and the issue rather is how far the legislature wanted to go in subordinating competing purposes, such as the raising of government revenues by taxation. Under either interpretation, exports are encouraged; they are encouraged more by the taxpayer's interpretation than by the tax collectors'; but the question is whether Congress legislated *that* degree of encouragement. *Rodriguez v. United States*, 480 U.S. 522, 525-26 (1987) (per curiam); *Stomper v. Amalgamated Transit Union*, No. 93-3468, slip op. at 6-7 (7th Cir. June 22, 1994); *Bushendorf v. Freightliner Corp.*, 13 F.3d 1024, 1026 (7th Cir. 1993). Perhaps mindful that reference to purpose is inconclusive in a case such as this, ADM argues that its interpretation is also compelled by, rather than merely being consistent with, the statutory language. It

is not compelled. The exporter is allowed to fix a transfer price that will allow its "DISC to derive taxable income *attributable* to [the export] sale," 26 U.S.C. § 994(a), and in our hypothetical sale ADM has no income from its export sales. To read section 994(a) as implying that the 4-percent-of-gross-receipts method of calculating DISC income in subsection (1) is capped at the amount of taxable income derived from export sales is not inevitable, but it is plausible, and it is supported by the legislative history. Both committee reports describe the 4 percent of gross receipts method as a way of calculating a ceiling on allowable income. H.R. Rep. No. 533, 92d Cong., 1st Sess. 74 (1971); S. Rep. No. 437, 92d Cong., 1st Sess. 107 (1971). Legislative history is in bad odor in some influential judicial quarters, see, e.g., *United States v. Taylor*, 487 U.S. 326, 344-46 (1988) (concurring opinion) but it continues to be relied on heavily by most Supreme Court Justices and lower-court judges; and in the case of statutory language as technical and arcane as that of the DISC provisions, the slogan that Congress votes on the bill and not on the report strikes us as pretty empty. Even advised by his personal staff a member of Congress would have great difficulty figuring out the purport of 26 U.S.C. § 994(a)(1) without the aid of the committee reports. If he (or his staff) cannot rely on them as a guide to the meaning of the statute, we are not sure what he is supposed to do.

Interpreted as ADM would interpret it, subsection (1) would have potentially far-reaching effects that we hesitate to impute to Congress without evidence that they were intended—effects such as encouraging purely domestic businesses to acquire export subsidiaries as tax shelters. A more plausible office to attribute to the subsection is that of serving as a complement to the next subsection. The exporter who has a low profit margin can use subsection (1) to shelter income up to 4 percent of his sales and the exporter with a high profit margin can use subsection

(2) to shelter up to half his profits without regard to his total sales. Evenhanded treatment of low-margin and high-margin exporters is achieved. The statute could be clearer but in light of the considerations that we have discussed it adequately supports the Treasury's regulation, to which we are supposed to accord a certain amount of deference even when as in this case it is "interpretive"—promulgated pursuant to the Treasury's general rulemaking authority—rather than being "legislative" in the sense of having been promulgated pursuant to a specific grant by Congress of authority to regulate the area in question. *Cottage Savings Ass'n v. Commissioner,* 499 U.S. 554, 560-61 (1991); *Gehl Co. v. Commissioner,* 795 F.2d 1324, 1328-29 (7th Cir. 1986).

The judgment for ADM is therefore

REVERSED.

HILL, J., dissenting *dubitante*:

At the outset, I make two acknowledgments. First, if the Secretary of the United States Treasury Department has the authority, in the form of regulation, to modify the Congressional statute before us by executive amendment, then the "no-loss rule" applies, and the opinion of the panel, as written by Chief Judge Posner, is absolutely correct. Second, the law, as crafted by the Treasury Department and approved by our panel today, may indeed be better than the one enacted by Congress.[1]

Nevertheless, I am unwilling to place my imprimatur upon Executive Branch legislation that makes changes in the statute that the Treasury Secretary believes are needed.[2] If the law is clear and unambiguous, I'd follow the law. If the law is unclear, then I'd give great deference to the interpretation of the agency involved. But, if the law says "drive from Washington to Baltimore," and the regulations say, "stop overnight in Annapolis," this direct conflict with the controlling statute should be declared invalid.

As I have said many times, I look respectfully upon the men and women of Congress as grownups who know what they are doing.[3] I find it inappropriate to patronize them

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[1] "It may be that the Act now created by our Court is a better or more complete Act than the one actually passed by the Congress. Who knows? Its deficiency is that . . . [it] was never submitted to the people's elected representatives and adotped by them." *Wilson v. First Houston Inv. Corp.* 566 F.2d 1235, 1243 (5th Cir. 1978) (Hill, J., dissenting), *vacated.* 444 U.S. 959 (1979).

[2] This is a personality disorder often found in bureaucrats and federal judges.

[3] "But if another course is to be chosen, the fine men and women who have been elected to represent the people are quite competent to the task. The judiciary should neither assume the responsibility nor usurp authority not delegated to it." *Roberts v. Austin,* 632 F.2d 1202, 1215 (5th Cir.1980) (Hill, J., concurring specially), *cert. denied,* 454 U.S. 975 (1981).

by noting their imperfect work and quietly correcting it. Moreover, I have even greater respect for Article I, Section 1 of the United States Constitution that confers the power to legislate upon these fine men and women. It doesn't confer that power upon the Treasury Department. It doesn't confer that power upon us, the judiciary.

Without the "no-loss rule," the judgment of the district court is correct. Having—not without some hesitation—concluded that Congress did not enact the "no-loss rule," I would affirm the judgment of the district court.

So I dissent.[4]

A true Copy:

Teste:

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Clerk of the United States Court of
Appeals for the Seventh Circuit

[4] This is probably just another example of the ongoing tension between the legislative, executive and judicial branches as to their appropriate roles under the Constitution.

APPENDIX B

[Filed Sep. 8, 1992]

IN THE UNITED STATES DISTRICT COURT
FOR THE CENTRAL DISTRICT OF ILLINOIS

Case Number 89-2325

ARCHER-DANIELS-MIDLAND COMPANY, *et al.*,
Plaintiffs,

vs.

UNITED STATES OF AMERICA,
Defendant.

ORDER

Archer-Daniels-Midland Company (ADM) brought this action against the United States of America on behalf of itself and as the common parent of an affiliated group of corporations. ADM is seeking a refund of federal taxes along with interest paid to the United States for the tax years 1975 through 1978. The parties have filed cross motions for partial summary judgment. (docket #17 and 19) The only issue involved in these motions is whether Treas. Reg. § 1.994-1(e)(1)(i), 26 C.F.R. § 1.994-1(e)(1)(i), which limits the use of two methods for determining the taxable income of a domestic international sales corporation (DISC), is valid.[1] For the reasons set forth below, the court agrees with the plaintiffs that Treas. Reg. § 1.994-1(e)(1)(i) is invalid.

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[1] The remaining issue in the case concerns the taxation of insurance transactions involving ADM's two wholly-owned foreign subsidiaries engaged in the insurance business.

I. INTERNAL REVENUE CODE SECTION AND TREASURY REGULATION

Congress enacted the DISC provisions, 26 U.S.C. §§ 991-997,[2] as a part of the Revenue Act of 1971. The purpose of the provisions "was to provide tax incentives for United States firms to increase their exports and to remove the previous tax disadvantage of firms engaged in export activities through domestic corporations instead of through foreign subsidiaries." *Thomas International, Ltd. v. United States,* 773 F.2d 300, 301 (Fed. Cir. 1985), *cert. denied,* 475 U.S. 1045 (1986); *LeCroy Research Sys., Corp. v. Commissioner,* 751 F.2d 123, 124 (2d Cir. 1984). These provisions authorize the exporters to establish DISCs as separate subsidiaries to handle foreign sales and leases. The basic function of a DISC, under section 993, "is the selling or leasing of export property which has been created by someone else in the United States for ultimate use outside the United States." *Gehl Co. v. Commissioner,* 795 F.2d 1324, 1326 (7th Cir. 1986) (quoting Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 17.14.2 (4th ed. 1979)). In essence, a DISC may be only a shell corporation whose sole function is to receive income from foreign sales by the parent corporation. *Thomas International,* 773 F.2d at 301; *see Dresser Indus. v. Commissioner,* 911 F.2d 1128, 1131 (5th Cir. 1990) ("Typically, a DISC is a paper company without facilities, employees, or inventory of its own.").

The tax advantages of the DISC provisions stem from the fact that a DISC is not subject to federal income tax on its income from export sales. *Durbin Paper Stock Co. v. Commissioner,* 80 T.C. 252, 254 (1983). Instead, approximately one-half of the DISC's earnings is taxed to its shareholders as constructive dividends. The remainder of the earnings is not taxed until actually dis-

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[2] All statutory references in this order are to sections of the Internal Revenue Code of 1954 (26 U.S.C.).

tributed to the shareholders. *See Gehl*, 795 F.2d at 1327; *Thomas International*, 773 F.2d at 301; *LeCroy*, 751 F.2d at 124. However, the statute provides that the exempted earnings must be used in export activities and not diverted to production for the domestic market or to production overseas. To fulfill the purposes of the DISC provisions, the DISC scheme includes strict requirements for qualification as a DISC and provisions regulating "transactions and transfers involving the flow of the DISC's tax-deferred profits to related entities." *Gehl*, 795 F.2d at 1326.

The DISC can participate in export transactions in two different ways. In each type of transaction, the DISC deals with a "related supplier" [3] in the sale of export property [4] to a third party. In the first type of transaction, the DISC operates as a principal in the resale of export property that the DISC purchased from the related supplier. Here the DISC earns income on the resale which the related supplier would otherwise have earned. In the second type of transaction, the DISC acts as a commission agent facilitating the sale of export property directly from the related supplier to the third party. The DISC's earnings in this transaction include commissions which the related supplier can deduct as commission expenses to reduce taxable income.

One provision that regulates the flow of the DISC's profits to related entities is section 994. This section sets forth inter-company pricing rules used to determine the DISC's taxable income. As established in this section, DISC taxable income is "based on a . . . 'deemed' trans-

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[3] A "related supplier" is a related party as defined in 26 U.S.C. § 482 that engages in a transaction with the DISC under the rules of 26 U.S.C. § 994. In this case, ADM and its affiliated corporations acted as the related suppliers for their DISC, Ardanco, Inc., a wholly-owned DISC of ADM.

[4] For the purposes of the DISC provisions, export property is defined in 26 U.S.C. § 993(c).

fer price for export goods provided to the DISC by its parent or related supplier." *Dresser*, 911 F.2d at 1131. The statute includes three alternative formulas for determining the "deemed transfer price." *Id.* Section 994(a) states:

> In the case of a sale of export property to a DISC by a [related supplier], the taxable income of such DISC and such person shall be based upon a transfer price which would allow such DISC to derive taxable income attributable to such sale (regardless of the sales price actually charged) in an amount which does not exceed the greatest of—
>
> (1) 4 percent of the qualified export receipts on the sale of such property by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts,
>
> (2) 50 percent of the combined taxable income of such DISC and [the related supplier] which is attributable to the qualified export receipts on such property derived as the result of a sale by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts, or
>
> (3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482).

26 U.S.C. § 994(a). The three alternative inter-company pricing methods for computing the taxable income from the export sales are known as the 4 percent gross receipts method, the combined taxable income method, and the section 482 method.[5]

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[5] The government explains that this third method was the traditional arm's-length method used to determine taxable income and the first two methods are the special ones created to promote exports by U.S. companies. *See* Government's Memo in Support of Summary Judgment at 8. (Government's First Memo at 8) (docket #20).

Although section 994(a) specifically applies only to transactions in which the DISC acts as a principal, section 994(b) directs the Secretary to prescribe rules to apply when the DISC acts as a commission agent.[6] The rules are found in inter-company pricing rules for DISCs, 26 C.F.R. § 1.994-1(d) (1991). These rules apply the 4 percent gross receipts method (called simply the "gross receipts method" in the regulations) and the combined taxable income method in sections 994(a)(1) and (2) to commissions.

The Secretary also has issued regulations concerning the application of the three pricing methods. Treasury Reg. 1.994-1(e)(1)(i) limits the situations in which the 4 percent gross receipts method and the combined taxable income method may be applied. The regulation provides:

> (e) Methods of applying paragraphs (c) and (d) of this section—(1) Limitation on DISC income ("no loss" rule)—(i) In general. Except as otherwise provided in this subparagraph, neither the gross receipt method nor the combined taxable income method may be applied to cause in any taxable year a loss to the related supplier, but either method may be applied to the extent it does not cause a loss. A loss to a related supplier would result if the taxable income of the DISC would exceed the combined taxable income of the related supplier and the DISC. If, however, there is no combined taxable income

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[6] Section 994(b) provides:

> The Secretary shall prescribe regulations setting forth—
>
> (1) rules which are consistent with the rules set forth in this subsection (a) for the application of this section in the case of commissions, rentals, and other income, and
>
> (2) rules for the allocation of expenditures in computing combined taxable income under subsection (a)(2) in those cases where a DISC is seeking to establish or maintain a market for export property.

> of the DISC and the related supplier (because, for example, a combined loss is incurred), a transfer price (or commission) will not be deemed to cause a loss to the related supplier if it allows the DISC to recover an amount not in excess of its costs (if any).

26 C.F.R. § 1.994-1(e)(1)(i) (1991). Under this regulation, also called the no-loss rule, a party, such as ADM, cannot use the 4 percent gross receipts method if the application of that method would result in a loss for the related supplier. ADM challenges the validity of this regulation.

II. FACTS

Since the parties have agreed to the facts surrounding the transactions and have submitted a stipulation stating the facts (docket #18), the court will review the facts briefly. In March, 1972, ADM incorporated a wholly-owned subsidiary, Ardanco, Inc. (Ardanco), to act as a DISC of ADM within the meaning of Section 992(a). Stipulation para. 10. During the tax years 1975 through 1978, Ardanco received commissions and transfer price income from transactions with its related suppliers, ADM, ADM Milling Company, ADM Export Company, Ross & Rowe, Inc., and Tabor & Company. Stipulation ¶¶ 21-22. In each of those years, transactions involving Ardanco and its related suppliers were subject to suppliers' agreements that provided that "the transfer price paid . . . by Ardanco . . . or the commission . . . payable to Ardanco . . . will be established in accordance with a formula which will entitle Ardanco to derive the maximum taxable income from such sales which may be allocated to it under the intercompany pricing rules as set forth in section 994 of the Internal Revenue Code." Stipulation ¶ 21. ADM established intercompany accounts payable and accounts receivable based upon the pricing methods in section 994(a) and, in its tax returns, computed its commissions and transfer prices applying the no-loss limitation. Stipulation ¶¶ 22-23.

ADM now argues, as it did in protests and refund claims filed for the years 1975 through 1978, that the no-loss rule is contrary to the 4 percent gross receipts method in section 994(a)(1) and is invalid. Stipulation ¶ 24. Without the no-loss limitation, ADM's taxable income would decrease and Ardanco's taxable income would increase. ADM seeks a refund based on the calculation of its taxes under the 4 percent gross receipts method, without the limitation of the no-loss rule.

III. DISCUSSION

Summary judgment is appropriate on the issue of the validity of the no-loss regulation since no material facts exist concerning this issue. The court's role in determining the validity of a Treasury regulation is limited. *Gehl,* 795 F.2d at 1328. Ordinarily, a court should defer to the regulation if the court concludes that "the regulation 'implement[s] the congressional mandate in some reasonable manner.' " *United States v. Vogel Fertilizer Co.,* 455 U.S. 16, 24 (1982) (quoting *United States v. Correll,* 389 U.S. 299, 307 (1967)); *Gehl,* 795 F.2d at 1328 (listing citations); *see American Medical Assoc. v. United States,* 887 F.2d 760, 770 (7th Cir. 1989) ("Treasury regulations 'must be sustained unless unreasonable and plainly inconsistent with the revenue statutes' "). But this general deferential standard is only the beginning of the necessary analysis. This standard is further refined by the source of authority under which the challenged regulation was issued." *Gehl,* 795 F.2d at 1328 (citations omitted).

The Commissioner may issue a regulation under the general grant of authority to "prescribe all needful rules and regulations," section 7805(a), or under a specific statutory grant of authority. *Gehl,* 795 F.2d at 1328. A court owes less deference to a regulation issued under section 7805(a)'s general grant of authority, an interpretative regulation, than to a regulation issued under a

specific grant of authority, a legislative regulation. *Rowan Cos. v. United States,* 452 U.S. 247, 253 (1981); *Gehl,* 795 F.2d at 1328. When reviewing a legislative regulation, a court's inquiry is limited to "whether the interpretation or method is within the delegation of authority." *Rowan,* 452 U.S. at 253. Legislative regulations are controlling "unless they are arbitrary, capricious, or manifestly contrary to the statute." *Dresser,* 911 F.2d at 1137 (citations omitted). A court will uphold an interpretative regulation as a reasonable interpretation of the congressional mandate only if it harmonizes with the statute's language, origin, and purpose. *Vogel,* 455 U.S. at 25; *National Muffler Dealers Ass'n v. United States,* 440 U.S. 472, 477 (1979). But the court must "scrutinize a regulation's fidelity to the overall statutory framework and legislative history." *Water Quality Ass'n Employees' Benefit Corp. v. United States,* 795 F.2d 1303, 1305-06 (7th Cir. 1986) (when appropriate, court may substitute its judgment for an agency's when the regulation is interpretative). Thus, the weight that the court will accord to the regulation depends on the regulation's source of authority. *Dresser,* 911 F.2d at 1137.

A. *Source of Authority*

The source of the authority for Treas. Reg. § 1.994-(e)(1)(i) is not clear. The government argues that the no-loss rule is valid either as a legislative regulation authorized by section 994(b)(1) or as an interpretative regulation. To support its assertion that the no-loss rule is a legislative regulation, the government explains that the three inter-company pricing methods in section 994(a) literally apply only to a DISC operating on a buy-sell basis. When a DISC, like Ardanco, also acts as a commission agent, it must look to the regulations promulgated under section 994(b)(1) to obtain the DISC tax benefits. Treasury Reg. § 1.994-1(d)(2) allows commission DISCs to use the 4 percent gross receipt method.

> The challenged "no-loss" rule is located in the next subparagraph (e) of the regulation, which sets forth the "methods of applying paragraphs (c) and (d) of this section." Accordingly, it is apparent that the "no-loss" rule is part of an integral set of regulatory provisions authorized by I.R.C. Section 994(b)(1) for establishing the parameters of the intercompany pricing methods for a commission DISC situation.

Government's Second Memo at 6. (docket #26)

ADM argues that the regulation is interpretative because neither section 994 nor any other DISC provision in the code gives the Treasury Department the regulatory authority to limit the 4 percent method. Specifically, ADM asserts that the only statutory grant of authority relating to the inter-company pricing rules is found in section 994(b)(1) and (2). The grant of authority in section 994(b)(1) does not encompass the authority to promulgate the no-loss rule, ADM contends, because this section provides only for the extension of the three pricing methods in section 994(a) to DISC commission transactions. Section 994(b)(1) directs the Secretary to issue regulations that set forth "rules which are consistent with the rules set forth in subsection (a) for the application of this section in the case of commissions, rentals, and other income." The inclusion of the words "consistent with" indicates that section 994(b)(1) does not authorize the Secretary to promulgate regulations, such as the no-loss rule, which limit the inter-company pricing methods. In addition, the no-loss rule applies to commission DISCs and to DISCs acting as the principal in a transaction. The grant of authority in section 994(b)(2) is also irrelevant here, according to ADM, because it deals only with the combined taxable income method. ADM also points to the Treasury Decision issuing the rules that states the decision is issued under the authority of section 7805. T.D. 7364, 1975-2 C.B. 315, 328.

Although no court has determined whether the no-loss rule is a legislative or interpretative regulation, several courts have discussed section 994(b)(1)'s grant of authority in regulation to other DISC regulations. In *Gehl*, the Seventh Circuit discussed whether section 994(b)(1) authorized the Secretary to promulgate Treas. Reg. § 1.993-2(d)(2). The Court quoted the Committee Reports explaining the grant of authority in section 994(b)(1):

> [T]he Secretary of the Treasury may prescribe by regulations intercompany pricing rules, consistent with those provided by the bill, in the case of export transactions where the DISC does not take title to the property, but instead, acts as a commission agent for the sale, or is a lessee of the property which it then subleases to its customers.

Gehl, 795 F.2d at 1329 (quoting S. Rep. No. 437, 92d Cong., 1st Sess. 108 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1918, 2014; H.R. Rep. No. 533, 92d Cong., 1st Sess. 75 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1825, 1888).[7] Another court explained the grant of authority in section 994(b)(1) as "expressly delegat[ing] to the Commissioner the authority to issue regulations regarding the amount of commissions to be charged in transactions between related persons." *CWT Farms, Inc. v. Commissioner*, 79 T.C. 1054, 1066 (1982), *aff'd*, 755 F.2d 790 (11th Cir. 1985), *cert. denied*, 477 U.S. 903 (1986).

In *Dresser*, the Fifth Circuit analyzed the source of authority of Treas. Reg. § 1.994-1(c)(6)(v). Just as in this case, the Treasury Decision promulgating the regulation at issue in *Dresser* stated that the regulation was is-

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[7] Because the *Gehl* court agreed with the Commissioner that the source of the regulation's authority did not affect the outcome of the analysis in that case, the court assumed, without deciding, that the challenged regulation was issued under the general grant of authority in section 7805(a) and applied the less deferential standard. 795 F.2d at 1329-30.

sued under the general grant of authority in section 7805 (a). However, the court stated that it was "not bound by mere nomenclature used by the issuing agency." 911 F.2d at 1138. Instead, the court found that the proper approach to determining the regulation's source of authority was to examine the statutory language and the regulation itself. *Id.* at 1138-1139. After analyzing the language and the legislative history of section 994(b), the court concluded that "Congress intended the tax treatment of commission DISCs to be consistent with the treatment of buy-sell DISCs. Congress specifically authorized the Secretary to make rules ensuring that consistency." *Id.* at 1139. In finding that Treas. Reg. § 1.994-1 (c)(6)(v) is a legislative regulation, the court relied on two facts: (1) the regulation "is directed exclusively to the calculation of deemed intercompany transfer prices in the case of commission DISCs," and, thus, falls within the rulemaking authority granted in section 994(b), and (2) the regulatory provisions which "fall squarely within the specific grant of rulemaking authority set out in code section 994(b)," section 1.994-1(d), incorporate section 1.994-1(c)(6) by reference. *Id.* at 1140.[8]

Following the analysis set forth in *Dresser*, the court concludes that Treas. Reg. § 1.994-1(e)(1)(i) is an interpretative regulation. Section 994(b) authorizes the Secretary to prescribe regulations for determining the deemed transfer price in transactions involving commission DISCs and to ensure consistency in the treatment of commission and buy-sell DISCs. The no-loss rule exceeds this grant of authority. Although the no-loss rule directly relates to the calculation of the deemed transfer

[8] In *LeCroy*, the court found that Treas. Reg. § 1.994-1(e)(3) is a legislative regulation since it furthers the same goal as the rules governing payments in a section 994 transaction and prevents the circumvention of other statutory limitations on DISCs. 751 F.2d at 125-26. *But see Thomas International*, 773 F.2d at 303. Like the regulation at issue in *Dresser*, the challenged regulation in *LeCroy* related exclusively to commission DISCs.

price of export goods under section 994, it applies a limitation to the calculation of the transfer price in transactions involving both commission DISCs and buy-sell DISCs. In addition, the government does not argue that the no-loss rule furthers the same goal as the rules in section 994 and, thus, must come under the same grant of authority. *See Gehl,* 795 F.2d at 1329 (discussing *LeCroy*).

B. *The Terms that the Regulation Interprets*

After determining the source of authority of a challenged regulation, the general deferential standard used in assessing the validity of a regulation is refined further by focusing on the term that the regulation interprets. *Gehl,* 795 F.2d at 1330. "Where the term that the regulation purports to interpret has already been specifically defined by Congress, the Commissioner's authority to promulgate the regulation is relatively more circumscribed than if the term used is a general one that was not further defined by Congress." *Id.* (citing *Vogel,* 455 U.S. at 24); *Thomas International,* 773 F.2d at 303. In other words, if the statutory language is unambiguous, the Commissioner has less freedom to define and interpret it. A regulation that contradicts the unambiguous language of the statute or adds a requirement to the statute without a valid reason cannot stand. *CWT Farms,* 79 T.C. at 1062 (citations omitted); *Arrow Fastener Co. v. Commissioner,* 76 T.C. 423, 430 (1981). "Finally, although a regulation does not clearly contradict or limit the provisions of the statute it purports to interpret, it is nonetheless invalid if it is inconsistent with the statute's origin and purpose." *CWT Farms,* 79 T.C. a 1062 (citing *Vogel,* 455 U.S. at 26).

ADM maintains that section 994(a)(1) is unambiguous. The Congressional language in section 994(a), ADM contends, is clear and precise in its creation of a mathematical formula for establishing the taxable income

of a DISC. ADM rejects any contention that section 994 is merely a general framework and insists that, if Congress had intended to enable the Treasury Department to lower the 4 percent formula in certain situations, Congress would have given the Treasury Department such explicit regulatory power.

The government, on the other hand, argues that section 994(a) does not state a clear mathematical rule. And, according to the government, the Secretary followed the express intent of the Congressional Committees by promulgating the no-loss rule. The government relies on reports of the House Ways and Means Committee, the Senate Finance Committee, and the Joint Committee on Internal Revenue Taxation which include this statement concerning section 994(a)(1) and (2):

> Under the first of the two new rules, a DISC may earn that portion of the combined taxable income arising on the sale by a DISC of export property purchased from a related person which does not exceed 4 percent of the qualified export receipts from the sale, plus 10 percent of the DISC's export promotion expenses attributable to the sale. Income may not, however, be allocated to the DISC under this (or the second) rule to the extent it would result in the related person who sold the products to the DISC incurring a loss on the sale.

H.R. Rep. No. 533, 92d Cong., 1st Sess. 74 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1825, 1887; S. Rep. No. 437, 92d Cong., 1st Sess. 107-108 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1918, 2013; Joint Committee on Taxation, *General Explanation of the Revenue Act of 1971,* at 102 (1972).

To support the no-loss rule as a reasonable interpretation of section 994(a), the government disputes ADM's characterization of section 994(a) as a mathematical formula. To the government, the language of the statute clearly demonstrates that 994(a) is not a mathematical

formula and is appropriate for regulatory interpretation. Specifically, the fact that the language in section 994(a) allows the DISC to derive taxable income which *"does not exceed the greatest of"* the three pricing methods indicates that Congress intended to create a general framework which the Secretary would interpret. This language does not mandate the use of a specific 4 percent mathematical formula at all times; rather, any amount less than the amount calculated under the 4 percent method "does not exceed" the statutory limitation and can be used.

The court finds that the language of section 994(a) is unambiguous. Unlike statutory sections which contain terms that require further definition, such as "accounts receivable," section 994(a) has been specifically defined by Congress. The government's reliance on the phrase "an amount which does not exceed the greatest of" is misplaced. The plain meaning of this phrase when followed by three alternative methods is that the taxpayer can choose one of the three methods, including one that allows the DISC to derive less taxable income than another method. If the government's interpretation of this phrase were correct, the Secretary could promulgate regulations forcing the DISC to receive any amount less than the amount calculated under the three methods. Such a result would contradict the DISC provisions' purpose of encouraging exports. The Secretary cannot add a restriction or limitation to an unambiguous statutory provision. *Durbin Paper,* 80 T.C. at 257; *Arrow Fastener,* 76 T.C. at 431.

Moreover, because the court does not find doubt concerning the meaning of the terms in section 994(a), it will not look to the legislative history to discover a limitation that Congress did not include in the statute. *See In re Sinclair,* 870 F.2d 1340, 1344 (7th Cir. 1989) ("Legislative History helps us learn what Congress meant by what it said, but it is not a source of legal rules competing with those found in the U.S. Code."). Although the Committee reports indicate that the provisions do

not allow the related supplier to take a loss, the statute, as enacted, does not include this limitation. In addition, the government has not persuaded the court that the no-loss rule is in harmony with the statute's origin and purpose. Unlike the regulation at issue in *Gehl* or *Thomas International,* the government has not argued that this regulation is necessary to prevent circumvention of another statutory section in the DISC scheme. *See Gehl,* 795 F.2d at 1330; *Thomas International,* 773 F.2d at 304. Finally, the government cannot argue that the goal of encouraging exports through the use of domestic subsidiaries is furthered by this provision.

The government also asserts that sections 994(a)(1) and (2) only address the allocation of taxable income between the DISC and the related supplier, whereas the no-loss rule deals with the export transactions that result in less than zero taxable income for the related supplier.

> Specifically, the no-loss rule addresses the related but distinct issue of whether the related supplier may claim a deduction for a *loss* from the sale of export property which results in taxable income of less that $0 to the related supplier. The no-loss rule does not "modify" or "amend" the statutory provision, which clearly does not address the issue of the allowance of loss deduction.

Government's First Memo at 14. (docket #20) Moreover, the no-loss rule, according to the government, implements Congressional intent concerning the related supplier's ability to take a loss deduction. See Government's Second Memo at 11-15 for further argument concerning allocation of income under section 994(a). (docket #26) With this argument, the government appears to be trying to justify the no-loss rule even if section 994(a) is unambiguous.

ADM asserts that the government's attempt to characterize the no-loss rule as dealing with the allowance

of deductions misreads section 994(a). Using ADM's reasoning, section 994(a) does not allocate taxable income; instead, section 994(a) provides the basis for determining taxable income or, in other words, establishes the taxable income of the related supplier and the DISC from the export transaction. ADM claims that the government cannot and does not dispute the fact that the related supplier can have negative taxable income under the 4 percent method. If the taxable income is a negative amount, the unambiguous 4 percent method does not allow the Secretary to come in and change the result. In addition, ADM contends that the Internal Revenue Code sections dealing with deductions cannot support the no-loss rule. *See* Plaintiff's Second Memo at 8-9. (docket #23)

Cases discussing the inter-company pricing rules in section 994(a) refer to them as allocating profits, *Gehl,* 795 F.2d at 1327, as establishing a "deemed" transfer price used to calculate income, *Dresser,* 911 F.2d at 1131, and as allocating income. Even assuming that the purpose of the three methods in section 994(a) is to allocate income, the government's argument does not support the addition of a restriction to an unambiguous statutory section.

IT IS THEREFORE ORDERED that the plaintiffs' motion for partial summary judgment is GRANTED; the defendant's motion for partial summary judgment is DENIED.

IT IS FURTHER ORDERED that the court will hold a status hearing in this case by telephone conference call on October 20, 1992, at 10:30 a.m.

ENTER THIS 8th day of September, 1992.

/s/ Harold A. Baker
HAROLD A. BAKER
United States District Judge

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
Chicago, Illinois 60604

November 2, 1994

Before Hon. Richard A. Posner, Chief Circuit Judge
Hon. James C. Hill, Circuit Judge*
Hon. Kenneth F. Ripple, Circuit Judge

No. 93-3939

ARCHER-DANIELS-MIDLAND COMPANY, on its own behalf and as common parent of an affiliated group of corporations, FLEISCHMANN-KURTH MALTING COMPANY, INCORPORATED, and COEVAL, INCORPORATED,
Plaintiffs-Appellees,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant.

Appeal from the United States District Court
for the Central District of Illinois, Danville Division
No. 89 C 2325—Harold A. Baker, *Judge*

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* Hon. James C. Hill, of the Eleventh Circuit, sitting by designation.

ORDER

On October 13, 1994, plaintiffs-appellees filed a petition for rehearing with a suggestion for rehearing en banc. All the judges on the original panel have voted to deny the petition, and none of the active judges has requested a vote on the suggestion for rehearing en banc. The petition is therefore DENIED.

APPENDIX D

[Filed Oct. 12, 1993]

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF ILLINOIS

Case Number: 89-2325

ARCHER-DANIELS-MIDLAND COMPANY, (on its own behalf and as common parent of an affiliated group of corporations), FLEISCHMANN-KURTH MALTING CO., INC., and COEVAL, INC.

vs.

UNITED STATES OF AMERICA

JUDGMENT IN A CIVIL CASE

[XX] Decision by Court. This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED that the claims for relief designated as insurance matters set forth in the Complaint in this matter in paragraphs 20 through 34 and 70 through 72, and, insofar as they are based on the grounds stated in paragraphs 20 through 34, the claims set forth in paragraphs 43 through 64, 74 through 84, 92 through 95, and 102 through 120, be dismissed with prejudice pursuant to the stipulation of the parties filed July 7, 1993, each party to bear its own costs, including any possible attorneys fees or other expenses of litigation, with respect to such claims.

IT IS FURTHER ORDERED that the plaintiffs shall recover from the defendant United States of America pursuant to claims for relief, relating to the plaintiffs' do-

mestic international sales corporation, set forth in the Complaint in this matter in paragraphs 35 through 42, and, insofar as they are based on the grounds stated in paragraphs 35 through 42, the claims set forth in paragraphs 43 through 64, 73 through 84, 92 through 95, and 101 through 120, the sums of $2,116,171 in taxes and $578,108 in assessed interest for 1974, $4,859,697 in taxes and $2,286,572 in assessed interest for 1975, $9,547 and $751 in taxes attributable to carryback tax credits with respect to the separate returns for 1975 of Fleischmann-Kurth Malting Co., Inc. and Coeval, Inc., respectively, $4,139,230 in taxes and $2,048,820 in assessed interest for 1976, $2,666,746 in taxes and $157,506 in assessed interest for 1977, $4,116,484 in taxes and $2,858,285 in assessed interest for 1978 (totalling refunds of $17,908,896 in taxes and $7,929,291 in assessed interest), and statutory interest on all such amounts as provided by 26 U.S.C. 6621, each party to bear its own costs, including any possible attorneys fees or other expenses of litigation, with respect to such claims.

JOHN M. WATERS
Clerk

/s/ Mary C. Burnstein
(By) Deputy Clerk

Date October 12, 1993